FOCUS NOTE

Islamic Microfinance: An Emerging Market Niche

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An estimated 72 percent of people living in Muslim-majority countries do not use formal financial services (Honohon 2007).[1] Even when financial services are available, some people view conventional products as incompatible with the financial principles set forth in Islamic law. In recent years, some microfinance institutions (MFIs) have stepped in to service low-income Muslim clients who demand products consistent with Islamic financial principles—leading to the emergence of Islamic microfinance as a new market niche.

Islamic microfinance represents the confluence of two rapidly growing industries: microfinance and Islamic finance.[2] It has the potential to not only respond to unmet demand but also to combine the Islamic social principle of caring for the less fortunate with microfinance's power to provide financial access to the poor. Unlocking this potential could be the key to providing financial access to millions of Muslim poor who currently reject microfinance products that do not comply with Islamic law. Islamic microfinance is still in its infancy, and business models are just emerging.

In a 2007 global survey on Islamic microfinance, CGAP collected information on over 125 institutions and contacted experts from 19 Muslim countries. The survey and a synthesis of other available data revealed that Islamic microfinance has a total estimated global outreach of only 380,000 customers and accounts for only an estimated one-half of one percent[3] of total microfinance outreach.

The supply of Islamic microfinance is very concentrated in a few countries, with the top three countries (Indonesia, Bangladesh, and Afghanistan) accounting for 80 percent of global outreach. Nevertheless, demand for Islamic microfinance products is strong. Surveys in Jordan, Algeria, and Syria, for example, revealed that 20–40 percent of respondents cite religious reasons for not accessing conventional microloans.

Islamic microfinance has the potential to expand access to finance to unprecedented levels throughout the Muslim world.

This Focus Note provides an overview of the current state of the Islamic microfinance sector and identifies possible challenges to its growth. It is intended as an introduction to Islamic microfinance primarily for the donor community and other potential entrants into the market.

Principles of Islamic Finance

Islamic finance refers to a system of finance based on Islamic law (commonly referred to as Sharia[4]). Islamic financial principles are premised on the general principle of providing for the welfare of the population by prohibiting practices considered unfair or exploitative. The most widely known characteristic of the Islamic financial system is the strict prohibition on giving or receiving any fixed, predetermined rate of return on financial transactions. This ban on interest, agreed upon by a majority of Islamic scholars, is derived from two fundamental Sharia precepts:

- **Money has no intrinsic worth**. Money is not an asset by itself and can increase in value only if it joins other resources to undertake productive activity. For this reason, money cannot be bought and sold as a commodity, and money not backed by assets cannot increase in value over time.

1 Honohon's study finds that in the Islamic Development Bank's 56 member countries, only 28 percent of the adult population uses formal (or semi-formal) financial intermediaries, whether through deposit accounts or borrowing. This percentage includes non-Muslims living in such countries.

2 Today, the total assets of Islamic financial products is estimated at US$500.5 billion (The Banker 2007) and the Islamic finance industry's 100 largest banks have posted an annual asset growth rate of 26.7 percent, outpacing the 19.3 percent growth rate of their conventional counterparts (Kapur 2008).

3 Based on an estimated 77 million microcredit clients (Microfinance Information eXchange 2007a).

4 Sharia is derived from four sources. The main source of Sharia is the Quran, considered by Muslims to be divine scripture. The second most authoritative source of Sharia is hadith—the practice, conduct, and sayings of the Prophet Muhammad. If further clarity is required, jurists seek consensus on rulings among Islamic scholars. In the event that none of these sources provides the necessary legal authority, a jurist may use reasoning by analogy and apply an accepted principle or assumption to arrive at a rule of law. Adapted from http://www.expertlaw.com/library/family_law/islamic_custody.html (accessed 22 March 2008).

- **Fund providers must share the business risk**. Providers of funds are not considered creditors (who are typically guaranteed a predetermined rate of return), but rather investors (who share the rewards as well as risks associated with their investment).

Islamic finance, however, extends beyond the ban of interest-based transactions. Additional key financial principles include the following:

- **Material finality.** All financial transactions must be linked, either directly or indirectly, to a real economic activity. In other words, transactions must be backed by assets, and investments may be made only in real, durable assets. This precludes the permissibility of financial speculation, and therefore, activities such as short selling are considered violations of Sharia.
- **Investment activity**. Activities deemed inconsistent with Sharia, such as those relating to the consumption of alcohol or pork and those relating to gambling and the development of weapons of mass destruction, cannot be financed. In broader terms, Sharia prohibits the financing of any activity that is considered harmful to society as a whole.
- **No contractual exploitation**. Contracts are required to be by mutual agreement and must stipulate exact terms and conditions. Additionally, all involved parties must have precise knowledge of the product or service that is being bought or sold.

The jurisprudence used to engineer Sharia-based financial contracts is complex (see Box 1). Scholars must complete several years of training before becoming certified to issue financial rulings. The industry's most prominent Islamic finance scholars are in general agreement on the basic set of financial precepts listed above. However, there is no centralized Sharia finance authority, and consequently, there can be conflicting views on the implementation of these principles in designing and extending Islamic financial products.

Development of the Islamic Finance Industry

Growth of Islamic Finance

The global Islamic finance industry is rapidly growing. In the past 30 years, the industry has witnessed the development of over 500 Sharia-compliant institutions, whose reach now spans 75 countries (KPMG 2006). These institutions include 292 banks (fully Islamic institutions and those institutions with Islamic subsidiaries), 115 Islamic investment banks and finance companies, and 118 insurance companies. Today, the industry's total assets are estimated at US$500.5 billion (The Banker 2007).[5]

Since 2006, nearly 80 Islamic financial institutions have been newly established or are being created (The Banker 2007). The 100 largest wholly Sharia-compliant banks have posted an annual asset growth rate of 27 percent, outpacing the 19 percent growth rate of their conventional counterparts (Kapur 2008).

Demand for Sharia-compliant investment portfolio management is increasingly being met by Islamic investment funds, which include private equity funds and approximately 250 Sharia-compliant mutual funds, with assets under management valued in 2006 at US$16 billion (Forte and Miglietta 2008). The Islamic bonds (sukuks)[6] market is also growing since Malaysia's pioneering issuance of sukuks in 2001. The size of the sukuk market in 2007 was estimated at US$47 billion, compared with US$10 billion in 2005 (AME Info 2008). The Islamic insurance market remains in its formative stage of development, with

5 Despite the rapid growth of Islamic finance, it remains a very small portion of the global market. While the largest Islamic bank, Bank Melli of Iran, has US$22 billion in assets, Mizuho Financial Group of Japan, the conventional banking industry's largest bank, has total assets estimated at US$1.28 trillion. In fact, there are only six Islamic banks worldwide with assets exceeding US$10 billion.

6 Sukuks do not feature prominently in Islamic microfinance. For a discussion on sukuks, see Clifford Chance Limited Liability Partnership (2006).

Box 1. Basic Islamic Microfinance Contracts[a]

The following are the most widely available types of Islamic microfinance contracts. Each can either operate individually or be combined with other contracts to create hybrid instruments.

- **Murabaha Sale (cost plus markup sale contract)**. The most widely offered Sharia-compliant contract is murabaha, an asset-based sale transaction used to finance goods needed as working capital. Typically, the client requests a specific commodity for purchase, which the financier procures directly from the market and subsequently resells to the client, after adding a fixed "mark-up" for the service provided. It is permissible for the financial institution to appoint the client as an "agent" on its behalf (by means of a contract) to directly procure the commodity from the market. However, ownership of the commodity (and the risk inherent thereto) strictly lies with the financier until the client has fully paid the financier. In most cases, clients repay in equal installments. The markup is distinct from interest because it remains fixed at the initial amount, even if the client repays past the due date. Among the primary conditions for a murabaha sale to remain Sharia-compliant are (*i*) the financier must own the commodity before selling it, (*ii*) the commodity must be tangible, and (*iii*) the client must agree to the purchase and resale prices.[b]

- **Ijarah (leasing contract)**. Ijarah is a leasing contract typically used for financing equipment, such as small machinery. Duration of the lease and related payments must be determined in advance to avoid any speculation. For the transaction to be considered Islamic (and not a sale with camouflaged interest), the ijarah contract must specify that the ownership of the asset, and responsibility for its maintenance, remains with the financier. An ijarah contract may be followed by a sale contract, in which event the ownership of the commodity is transferred to the lessee.

- **Musharaka and Mudaraba (profit and loss sharing)**. The profit and loss sharing (PLS) schemes are the Islamic financial contracts most encouraged by Sharia scholars. **Musharaka** is equity participation in a business venture, in which the parties share the profits or losses according to a predetermined ratio. Musharaka can be used for assets or for working capital. **Mudaraba** denotes trustee financing, in which one party acts as financier by providing the funds, while the other party provides the managerial expertise in executing the project. In mudaraba, profits are shared according to a predetermined ratio; any losses are borne entirely by the financier. If the mudaraba joint venture results in a loss, the financier loses the contributed capital and the manager loses time and effort. Both PLS schemes require particularly vigilant reporting and a high level of transparency for profits and losses to be distributed justly. Consequently, though promoted strongly by Sharia, they result in substantial operating costs particularly for micro and small enterprises that are not accustomed to formal accounting.

- **Takaful (mutual insurance)**. The equivalent of Islamic insurance, takaful is a mutual insurance scheme. The word originates from the Arabic word "kafala," which means guaranteeing each other or joint guarantee. Each participant contributes to a fund that is used to support the group in times of need, such as death, crop loss, or accidents. Paid premiums are invested in a Sharia-compliant manner to avoid interest.

[a]There is only one type of permissible "loan" according to Sharia, the Qard-Hassan (or Benevolent) Loan, which is interest-free and often considered a form of charity because it is typically forgiven in the event of default. All other mechanisms are better termed financing agreements, or contracts. However, for the purposes of this Focus Note, the term "loan" may be used to denote financing arrangements within the Sharia context.
[b]Adapted from Khan (2008).
[c]For a detailed discussion of takaful, see Maysami and Kwon.

Box 2. How Does Savings Work?

Islamic savings products are deposits that are invested pursuant to the principles set forth in this paper. A typical savings product is a form of mudaraba, in which the saver "invests" her deposit in the business of a financial institution. The financial institution invests its managerial expertise and intermediates the deposits/investments in a Sharia-compliant manner. Profits (or losses) are shared pursuant to prior agreement. Such a savings arrangement also could be considered a form of musharaka because other depositors are also depositing funds for investment in the same financial institution. Even takaful can operate as a savings product because premiums are invested in a Sharia-compliant manner and are often disbursed at the end of an agreed term, regardless of any insurance claim.

an estimated US$5 billion in premiums held in 2007 against a global insurance turnover of US$3.7 trillion (Zawya 2008).

Global Expansion

Despite its origins in the Persian Gulf, Sharia-compliant banking has proved popular with Muslims in other countries as well, leading to the development of new Islamic banks across North Africa and Asia. Of the total US$500.5 billion global Islamic finance market, 36 percent is located in the Gulf Cooperation Council (GCC) countries (Bahrain, Kuwait, Oman, Qatar, Saudi Arabia, and UAE), 35 percent in non-GCC Southwest Asia and North Africa, and 23 percent in Asia (primarily Malaysia, Brunei, and Pakistan) (The Banker 2007).

Over time, Islamic financial services also have expanded well beyond the Muslim world and are offered not only by Islamic banks, but also by Islamic subsidiaries of international financial institutions. Islamic financial services are currently provided in countries such as India, China, Japan, Germany, Switzerland, Luxembourg, the United Kingdom, the United States, and Canada. The United Kingdom, which currently ranks tenth in The Banker's listing of "Top 15 Countries by Sharia-compliant Assets" (2007), has recently announced its aim to make London a global center for financial markets in the Muslim world.

Government Regulation

Islamic financial services originally operated in an unclear regulatory landscape. However, as they expanded, they presented several regulatory challenges that governments have attempted to address to various degrees.

One approach has been to proactively encourage, even mandate, Islamic financial services by law. Northern Sudan, for example, adopted Sharia-compliant regulatory frameworks for the entire banking sector in 1984. Indonesia broke new ground in the realm of Islamic finance by creating in 1992 a formal, regulated Sharia banking sector alongside, and not instead of, its conventional banking sector.[7] New regulations in Malaysia, Brunei, and Pakistan also have supported the expansion of an Islamic finance industry alongside conventional financial services.

A second regulatory approach has been to address the growth of Islamic finance by separately regulating unique aspects of Islamic banking, such as Sharia Supervisory Boards (SSBs). For example, several countries (such as Kuwait, Jordan, Lebanon, and Thailand) have regulated the competence and composition of SSBs, as well as related rules governing appointment, dismissal, and qualifications of SSB members (Grais and Pellegrini 2006). However, no country is known to regulate the Sharia jurisprudence to be used by SSBs in judging Sharia compliance (though countries like Jordan and Kuwait do impose SSB member unanimity or majority vote requirements) (Grais and Pellegrini 2006).

International Organizations

In parallel with increased attention by regulatory authorities, international organizations also have been created to set Islamic finance accounting and other standards:

- The Islamic Financial Services Board (IFSB), based in Malaysia, issues prudential standards and guiding principles for Islamic finance. IFSB has issued guidelines on risk management and capital adequacy for Islamic banks.
- The Accounting and Auditing Organization for Islamic Financial Institutions (AAOIFI), based in Bahrain, promotes financial reporting standards for Islamic financial institutions.

7 Decree No. 72 (1992) concerning Bank Applying Share Base Principles.

- The Islamic Development Bank (IDB), a multilateral body headquartered in Saudi Arabia, fights poverty and promotes economic development in Islamic country members. It promotes microfinance and poverty alleviation programs through its Islamic Solidarity Fund for Development (ISFD), which recently committed US$500 million to microfinance development through its Microfinance Support Program (MFSP).

Despite a shared core of Islamic values, these institutions often diverge with national regulators (and each other) over Sharia standards. For example, AAOIFI standards are mandatory in only a handful of countries and are selectively implemented elsewhere (Islamic Banking & Finance 2008).

Islamic Microfinance

Demand

Conventional microfinance products have been very successful in Muslim majority countries. One of the earliest microfinance programs originated in Bangladesh with the experience of the Grameen Bank initiated by Nobel Prize winner Mohammed Yunus. Islamic countries, such as Indonesia and Pakistan, have a vibrant microfinance industry; approximately 44 percent of conventional microfinance clients worldwide reside in Muslim countries.[8] Yet, conventional microfinance products do not fulfill the needs of many Muslim clients. Just as there are mainstream banking clients who demand Islamic financial products, there are also many poor people who insist on these products. Indeed, Sharia compliance in some societies may be less a religious principle than a cultural one—and even the less religiously observant may prefer Sharia-compliant products.

A number of IFC-commissioned market studies suggest a strong demand for Islamic microfinance products:

- More than 60 percent of low-income survey respondents in the West Bank and Gaza claim a preference for Islamic products over conventional products. More than half of such respondents prefer such products even if they come at a higher price (PlaNet Finance 2007).[9]
- In Jordan, studies by USAID (2002) and IFC/FINCA (2006) show that 24.9 percent and 32 percent, respectively, of those interviewed cite religious reasons for not seeking conventional loans. The IFC/FINCA study also showed that 18.6 percent of those interviewed rank religious reasons as the single most important factor in their decision on obtaining a loan.
- In Algeria, a 2006 study revealed that 20.7 percent of microenterprise owners do not apply for loans primarily because of religious reasons (Frankfurt School of Finance and Management 2006).
- In Yemen, an estimated 40 percent of the poor demand Islamic financial services, regardless of price.[10]
- In Syria, a survey revealed that 43 percent of respondents considered religious reasons to be the largest obstacle to obtaining microcredit. In addition, 46 percent of respondents who had never applied for a loan stated that religious reasons were the primary reason they had never applied. Nearly 5 percent of current borrowers said they would not apply for another loan for religious reasons (IFC 2007b).

In addition to the IFC–commissioned studies, a 2000 Bank Indonesia report indicated that 49 percent of the rural population of East Java considers interest prohibited and would prefer to bank with Sharia-compliant financial institutions.

Although there is a market of poor clients who strictly engage in Islamic transactions, there is also a category of Muslim clients who use conventional products but *prefer* Islamic ones. Microfinance

8 Based on figures provided by the Microfinance Information eXchange.
9 Thirty-five percent of West Bank respondents and 60 percent of Gaza Strip respondents stated that they do not access finance because of the Islamic prohibition on interest.
10 Phone interview with executive director of the National Microfinance Foundation, Yemen.

practitioners[11] in Muslim-majority countries indicate that in Afghanistan, Indonesia, Syria, and Yemen, some conventional microborrowers tend to switch over once Islamic products become available.

Anecdotal evidence, however, suggests that survey respondents may verbally express a preference for Islamic products simply to demonstrate piety or (when given a choice in practice) will opt for a lower priced conventional product. Consequently, despite indications of demand for Islamic microfinance products, further research is needed to ascertain the nature and extent of the demand and how to meet this demand in a cost-effective manner.

Government Promotion of Islamic Microfinance

As in the case of the larger Islamic banking industry, government regulation can play a significant role in the expansion of Sharia-compliant microfinance.

Indonesia. In Indonesia, the government has actively promoted Islamic microfinance. In 2002, Bank Indonesia prepared a "Blueprint of Islamic Banking Development in Indonesia" in which it developed a nine-year plan for development of the Islamic finance sector, including support for the 105 Sharia rural banks. Indonesia now provides a supportive regulatory framework and has licensed 35 new Islamic rural banks in the past five years. Bank Indonesia also is spearheading efforts in capacity building by establishing a center in Medan to offer training and certification on Islamic financial operations to Sharia rural bank staff, managers, and directors.

Pakistan. The State Bank of Pakistan, which already has a legal and regulatory framework in place for conventional MFIs, also developed guidelines in 2007 for the rapid expansion of Islamic microfinance. The guidelines stipulate four types of institutional arrangements for offering Islamic microfinance: via (*i*) the creation of Islamic microfinance banks, (*ii*) Islamic banks, (*iii*) conventional banks, and (*iv*) conventional microfinance banks. The guidelines set forth requirements regarding licensing, appointment of Sharia advisers to rule on Sharia compliance, and segregation of Islamic product funds (and related documentation) by banks and MFIs that offer both conventional and Sharia-compliant products.[12]

Banks Downscaling and Expanding Product Line

An encouraging development in the growth of Islamic microfinance is that Islamic commercial banks have started to offer Islamic microfinance services. Yemen's Tadhamon Islamic Bank, for example, opened a micro and small enterprises division in late 2006 (IFC 2007a). In addition, some Islamic banks are planning to offer Islamic microfinance products beyond just microcredit. On 20 January 2008, Noor Islamic Bank and Emirates Post Holding Group announced plans to establish a company that will offer Sharia-compliant banking services to the low-income segment of the UAE population. The proposed company will provide a wide array of Islamic microfinance products, including microcredit, insurance, debit and credit cards, remittance and currency exchange, and salary payments (Emirates News Agency 2008). Also in January 2008, Allianz Life Indonesia announced that, after an 18-month pilot project, the Sharia-compliant microinsurance "Family Umbrella" product is now an established line.

Islamic Microfinance: CGAP Survey Results

CGAP conducted a global survey on Islamic microfinance in 2007, collecting information on over 125 institutions and contacting experts from 19 Muslim countries. This section presents the principal

11 These practitioners include FINCA (Afghanistan), German Technical Cooperation (Indonesia), Sanadiq in Jabal-al-Hoss (Syria), Social Fund for Sustainable Development (Yemen), and Hodeidah Microfinance Program (Yemen).

12 Guidelines for Islamic Microfinance Business for Financial Institutions (Annexure to Circular No. 05 of 2007), State Bank of Pakistan Islamic Banking Department, available at http://www.sbp.org.pk/ibd/2007/Annex-c5.pdf.

Box 3. What About Iran?

The Iranian government requires all of its commercial banks to provide Sharia-compliant noninterest bearing loans to the low-income population. Typically, these loans are disbursed to cover personal expenses, such as wedding expenses, repayment of outstanding debts, home rental and repair costs, medical expenses, tuition fees, and the purchase of consumer goods. Outreach is very significant and, as of March 2008, the Central Bank of Iran estimated that 3 million families benefit from approximately 6,000 Qard-Hassan institutions ("benevolent loan funds" known in Iran as Qarzul-Hassaneh Funds), with a total outstanding loan amount of 50 trillion rials (or US$5.5 billion). However, Qarzul-Hassaneh Funds are most often considered charities, and not MFIs, because loans are typically (*i*) made for large one-time expenditures and (*ii*) forgiven in the event of default. They are not generally considered to provide access to finance in a sustainable manner.

Outside the Qarzul-Hassaneh Funds, microfinance in Iran is informal, though a number of originally charitable organizations have reportedly started microfinance operations. These organizations have been registered by the Ministry of Interior and are outside the scope of Central Bank regulation.

Consequently, statistics on Iranian microfinance and Qarzul-Hassaneh Funds are not reflected in this Focus Note.

findings of this first global survey on the performance and outreach of Islamic microfinance.

Current Performance

The outreach of Islamic finance is very limited. According to the CGAP survey, Islamic MFIs[13] reach 300,000 clients through 126 institutions operating in 14 countries and an estimated 80,000 clients through a network of Indonesian cooperatives. According to the survey, Bangladesh has the largest Islamic microcredit outreach, with over 100,000 clients and two active institutions. However, Bangladesh is also the country where conventional microfinance products have the largest outreach—nearly 8 million borrowers—and Islamic microfinance represents only 1 percent of its microfinance market.

In all Muslim countries, Islamic microfinance still accounts for a very small portion of the country's total microfinance outreach. For example, in Syria and Indonesia, Islamic financing instruments comprised only 3 percent[14] and 2 percent, respectively, of outstanding microfinance loans in 2006. In addition, the average outreach of the 126 institutions covered by the CGAP survey is only 2,400 clients (and none has more than 50,000 clients).

The supply of Islamic microfinance is very concentrated in a few countries. Indonesia, Bangladesh, and Afghanistan account for 80 percent of the global outreach of Islamic microfinance. In all other countries, microfinance is still in its infancy, with no scalable institutions reaching clients on a regional and national level.

For most countries, the average Islamic microloan amount (with respect to primarily the murabaha product) is similar to conventional microloans. There are notable exceptions, however, such as in Indonesia (where the average Islamic product loan size is 45 percent higher than the average conventional microloan)[15] and in the West Bank and Gaza.

Like conventional microfinance, Islamic microfinance tends to focus on female clients—a majority of Islamic MFI clients according to the CGAP survey were women (59 percent on average, but up to 90 percent in Bangladesh). Overall, the percentage of female clients using Islamic microfinance products (59 percent) is comparable to those using conventional

13 The term "Islamic MFI" in this Focus Note refers to any institution offering Islamic microfinance services and not just to Islamic institutions.
14 Sanabal Microfinance Network data.
15 Microfinance Information eXchange.

Table 1. Outreach of Islamic Microfinance, by Country

Region	# of Included Institutions	% Female (Avg.)	Total # of Clients	Total Outstanding Loan Portfolio (US$)	Avg. Loan Balance (US$)
Afghanistan	4	22	53,011	10,347,29	162
Bahrain	1	n/a	323	96,565	299
Bangladesh	2	90	111,837	34,490,490	280
Indonesia*	105	60	74,698	122,480,000	1,640
Jordan	1	80	1,481	1,619,909	1,094
Lebanon	1	50	26,000	22,500,000	865
Mali	1	12	2,812	273,298	97
Pakistan	1	40	6,069	746,904	123
West Bank and Gaza**	1	100	132	145,485	1,102
Saudi Arabia	1	86	7,000	586,667	84
Somalia	1	n/a	50	35,200	704
Sudan	3	65	9,561	1,891,819	171
Syria	1	45	2,298	1,838,047	800
Yemen	3	58	7,031	840,240	146
TOTAL	126	59	302,303	197,891,882	541

* Micro and rural banks only.
**There were seven MFIs in the West Bank and Gaza that offered, with the help of training and funding facilities offered by the Islamic Development Bank, a total of 578 Islamic loans between 2005 and 2006. Data on only one of these seven are displayed in the table because the remaining six MFIs were disbursing Islamic loans with average loan sizes higher than 250 percent of the region's gross domestic product per capita.

microfinance products (65.7 percent globally, and 65.4 percent in the Arab world) (Microfinance Information eXchange 2007b).

Finally, the CGAP survey identified that over 70 percent of the products offered are murabaha. Islamic MFIs generally offer only one or two Sharia-complaint products. Concentrating primarily on asset financing, the industry still lacks product diversification to serve the various financial needs of the poor.

Table 1 includes the outreach data of only the institutions that CGAP was able to contact during its survey, except with respect to those institutions in Indonesia (about which information was obtained from the Indonesian Central Bank's 2007 Statistics) and in the West Bank and Gaza (about which information was provided by the Deprived Families Economic Empowerment Program). The table excludes the outreach of Indonesia's 4,500 Islamic cooperatives. However, according to experts in Indonesia, only 60 percent of these Islamic cooperatives are still active, and their total outreach is estimated at 80,000 clients. As in the rest of this Focus Note, an MFI is defined as an institution targeting the poor and whose average loan size is less than 250 percent of the country's gross domestic product per capita.

Islamic Microfinance by Institution Type

Among the institutions that offer Islamic microfinance products, nongovernment organizations (NGOs) are the dominant players in reaching the largest number of clients, with just 14 institutions reaching 42 percent

Table 2. Outreach of Islamic Microfinance, by Institution Type

		Total # of Clients		Total Outstanding Loan Portfolio (Islamic)		Avg. Loan Size (Islamic)
Institution Type	**# of Institutions**	**#**	**% of Total**	**US$**	**% of Total**	**US$**
Cooperative	1	6,671	2	926,251	<1	132
Village Bank (Syria)	1	2,298	1	1,838,047	<1	800
NGO	14	125,793	42	41,421,580	21	303
Rural Bank (Indonesia)	105	74,698	25	122,475,158	62	1,640
NBFI	3	4,293	1	1,893,207	<1	595
Commercial Bank	2	87,569	29	29,030,997	15	305
TOTAL	126	305,237	100	198,090,268	100	629

Note: This table reflects the data of only those institutions (mixed and fully Islamic) that provided reliable outreach information to CGAP during its 2007 global survey of Islamic microfinance. Data regarding the 105 rural banks in Indonesia were obtained from the Indonesian Central Bank's 2007 Statistics. This table excludes data on the outreach of Indonesia's 4,500 cooperatives. As in the rest of this Focus Note, an MFI is defined as an institution targeting the poor and whose average loan size is less than 250 percent of the country's gross domestic product per capita.

of clients. Commercial banks (represented by only two institutions: Yemen's Tadhamon Islamic Bank and Bangladesh's Islami Bank Bangladesh Limited) have the second largest outreach with over 87,000 clients. Interestingly, 105 Sharia-compliant rural banks in Indonesia account for 25 percent of total clients, but 62 percent of the outstanding loan portfolio because of their significantly higher average loan size and focus on small and microenterprise financing.

Focus on Indonesia

Indonesia gives insight into the development of Islamic microfinance because of its dual conventional/Islamic microbanking system, which includes both conventional rural banks (Bank Perkreditan Rakyat or BPRs) and Sharia-compliant rural banks (Bank Perkreditan Rakyat Syariah or BPRSs). BPRSs are privately owned and are regulated and supervised by Bank Indonesia. They are licensed to offer banking services (loans and savings facilities, but no payments services) in a district area only. As of December 2006, there were 1,880 BPRs and 105 BPRSs.

BPRSs are more socially oriented than BPRs. Their mission statement calls for supporting the community and, in particular, microentrepreneurs. They also have strong links with Indonesian Muslim mass movements, such as Nahdlatul Ulama or Mohammedia. Each BPRS has a Sharia board to monitor the conformity of products to Islamic principles. However, board rulings are not consistent, and consequently, Islamic microfinance products can vary widely depending on the specific BPRS. BPRSs primarily offer murabaha products and savings services based on a revenue-sharing model.[16] They have been quite successful at mobilizing savings for the community, and their loan-to-deposit ratio is over 110 percent.

It is impossible to draw general conclusions on the performance of Islamic MFIs based only on the limited case of Indonesian BPRSs. Nevertheless, BPRSs offer some insights on profitability and efficiency.

Higher costs. The average operational efficiency ratio of BPRSs is 20 percent—higher than the 15 percent operational efficiency ratio for conventional BPRs.

16 This savings product is a form of mudarabah (see Box 1) in which the depositor acts as "financier."

Table 3. Financial Performance of Indonesian MFIs Compared to Small Asian MFIs

Institution Type	Number of Institutions	Average Total Assets (US$)	Average Outstanding Loan Portfolio (US$)	PAR > 30 days	Operational Efficiency Ratio	ROA
Sharia Rural Banks (BPRSs)	105	1,538,571	1,166,476	8.67%	20%	1.41%
Conventional Rural Banks (BPRs)	1,880	1,225,797	n/a	9.73%	16%	2.21%
Small Asian MFIs	30	1,244,593	886,728	1.90%	9.60%	3.40%

Source: Bank of Indonesia (2007a). Operational Efficiency figures are based on BPRs in North Sumatra (Microfinance Innovation Center for Resources and Alternatives).

The difference may reflect the higher transaction costs inherent in certain Sharia-compliant products. BPRSs are mainly engaged in murabaha, which incurs the expense of first procuring the commodity to be later resold and the expense of managing its resale through the murabaha contract. However, although overall transaction costs are higher, the extra cost to the customer may be offset by wholesale prices and the related saving of time otherwise spent selecting suppliers and negotiating contract terms. Both BPRs and BPRSs do not compare well with their closest "peers"—small MFIs in Asia[17]—as far as operational efficiency is concerned. This could be due to a number of factors, including average loan size, cost structure, and staff productivity.

Elevated portfolio delinquency, but improving over time. The average portfolio at risk (PAR) at 30 days for both BPRs and BPRSs are comparable at approximately 9 percent—high by microfinance standards. By comparison, small Asian MFIs have a PAR at 30 days of 1.9 percent. But over time, late payments seem to be recovered and long-term loss (defined as payments more than 180 days overdue) for BPRSs is reported at 3.1 percent.[18] Consequently, portfolio delinquency does not generate significant long-term loss.

Lower return on assets (ROA). The average ROA for BPRSs was 1.4 percent in 2006, significantly lower than the ROA of BPRs (2.2 percent). However, the range for both was wide, with several being very profitable and others not breaking even. BPRSs are still young institutions without a proven track record. It is too early to draw conclusions about BPRS profitability; however, several factors might explain a lower ROA, including the social mission of BPRSs.

BPRSs are meeting a growing demand for Sharia-compliant microfinance products. Their rate of growth has been impressive: from March to December 2007, these banks' murabaha receivables increased by 26 percent, musharaka financing increased by 27 percent, and mudaraba financing increased by almost 50 percent (Bank of Indonesia 2007b). BPRSs can be profitable but nevertheless, like many microfinance providers, they face several challenges in reaching sustainable scale (see Box 4).

Possible Challenges to the Growth of Islamic Microfinance

Islamic microfinance could potentially expand access to finance to unprecedented levels throughout the Muslim world. However, the industry has yet to demonstrate it can provide financial services that meet the needs of poor people on a large scale. A deeper base of market research and proven business models are very much needed. Nevertheless, several

17 As identified in the MicroBanking Bulletin (2007).
18 Statistik Perbanken Syariah (Islamic Banking Statistics), Bank Indonesia (Direktorat Perbanken Syariah), December 2007.

Box 4. A Tale of Two Islamic Microfinance Banks

BPRS Wakalumi in Ciputat, was established in 1990 by a foundation (Yayasan Wakalumi) as a conventional BPR; for religious reasons, it converted into a BPRS in 1994. It has 118 shareholders, among them Bank Muamalat Indonesia (19 percent, down from 49 percent), the former Minister of Cooperatives (23.5 percent), a Citibank manager (26 percent), the founding foundation Yaysan Wakalumi (5.6 percent), and more than 100 individuals, mostly Muslims working at Citibank.

The bank seems to have a successful staff promotion strategy: the president director, with a bachelor's degree in agriculture, has been with the bank since 1994, learning on the job and being promoted up the ranks; the director, a woman with a diploma in accounting, has been an employee since 1997 and was promoted to director in 2003. The bank has grown rapidly, and now has five branches and a staff of 38, including 13 loan officers.

Its 2,000 clients are mostly small traders on traditional markets, to whom it sells its financings as Islamic products. It has four financing products, with murabaha being the dominant one. Through eight savings products and four term deposit products, it has attracted 5,000 savers. With ROAs in 2001–2003 of 4.1 percent, 3.65 percent, and 3.35 percent and ROEs of 20.3 percent, 21.05 percent, and 24.1 percent, respectively, it is highly profitable.

BPRS Artha Fisabililah, in Cianjur, was established in 1994 by nine shareholders. By 1997, as a result of lack of management experience, it was technically bankrupt and was restructured. The new management was not very dynamic and was replaced in 2001 by a retired bank credit officer.

The bank, located next to a local market, has 1,150 savers and 163 clients. With a staff of 11, including six loan officers, it offers doorstep collection services to about 200 clients a day. It also offers deposit services to school children and institutions. Total assets are IDR 1.4 billion, deposits total IDR 0.62 billion, and financings outstanding equal IDR 1.21 billion.

Its overall performance is not yet satisfactory. Its main problem is lack of funds, because of a shortage of deposits and capital from the owners. The bank was in the black for the years 2001, 2002 and 2003, with ROAs of 2.3 percent, 1.7 percent, and 2.4 percent and ROEs of 7 percent, 4.3 percent, and 8.75 percent, respectively. Its main future strategy to improve efficiency is staff upgrading through training.

Source: Adapted from Seibel (2007).

possible challenges to scale up Islamic microfinance can be identified.

Building Sustainable Business Models

Islamic microfinance business models are still being developed and no performance benchmarks have been established. However, two areas are of particular importance: operational efficiency and risk management.

- **Operational efficiency**. Operational efficiency is key to providing affordable financial services to the poor. Managing small transactions is expensive, and MFIs must innovate to reduce transactions costs. In murabaha or ijara transactions, the provider of funds purchases a commodity (such as equipment or inventory) and resells or leases it to the user with a markup. Islamic MFIs may benefit from cheaper prices on the wholesale market, but the costs associated with purchasing, maintaining, selling, or leasing a commodity (such as a sewing machine) are expensive, and the added costs are often passed on to clients. However, some institutions have cut their costs in murabaha transactions by requiring the end user to search for and identify the desired

commodity. Islamic institutions should consider developing similarly novel techniques and practices to minimize costs and offer more attractive pricing to their clients.

- **Risk management.** Risk management is another important factor to building sustainable institutions. The conventional microfinance industry has developed a set of good practices to manage credit risk, and MFIs boast excellent portfolio quality.[19] Conventional MFIs generally do not secure loans through collateral but instead rely on peer pressure and strict discipline for collection. Such techniques should be adapted to comply with the risk-sharing, and no-interest principles embedded in Islamic finance. For example, some suggest that pressure from the religious community and appeals to a sense of religious duty should complement reliance on peer pressure.

The Question of Authenticity

Although there is ample evidence of demand for Islamic microfinance products, meeting such demand requires that low-income clients are comfortable that the products offered are authentically Islamic. Critics of Islamic finance products suggest that the pricing of some products offered as Sharia-compliant too closely parallels the pricing of conventional products. For example, some institutions offer murabaha where interest appears to be disguised as a cost markup or administration fee. Islamic finance sometimes suffers from the perception that it is simply a "rebranding" of conventional finance and not truly reflective of Islamic principles.

Consequently, low-income populations, who often rely on local religious leaders to address questions of religion, must be convinced of the authenticity of Islamic financial products if Islamic microfinance is to reach its full potential. Greater efforts should be explored to (*i*) increase collaboration between financial experts and Sharia experts on product authenticity, (*ii*) encourage exchange of experiences among religious leaders (particularly those serving poor populations at the local level) relating to Sharia compliance of microfinance products, and (*iii*) educate low-income populations, in collaboration with local religious leaders, on how financial products comply with Islamic law.

Building Capacity

Capacity building is needed at all levels to realize the full potential of Islamic microfinance. At the macro level, the Islamic Development Bank and Islamic financial standard setters (such as IFSB or AAOIFI) should consider developing global financial reporting standards adapted to microfinance to build the infrastructure for transparency in the global Islamic microfinance sector. This infrastructure would entail comprehensive disclosure guidelines on Islamic microfinance accounting principles, pricing methodologies, financial audits, and eventually, rating services.

At the micro and institutional levels, international donor agencies can play a major role in expanding access to finance in Muslim countries by helping existing institutions reach scale and funding pilot projects testing various business models. In addition, more efforts should be made to train Islamic MFI managers and staff through, for example, the development of operational tools and manuals (such as those developed by Deutsche Gesellschaft für Technische Zusammenarbeit for use in Indonesia).

Product Diversity

Islamic MFIs rely heavily on the murabaha (cost plus markup sale) product.[20] However, poor people have diverse financial requirements, and for many, savings or housing products may be more urgent needs. The

19 The 1,200 MFIs reporting to the Microfinance Information eXchange report an average PAR at 30 day is less than 5 percent.

20 The murabaha sale is the sole product of 34 percent of the MFIs operating in Northern Sudan. In addition, as of December 2006, murabaha sales accounted for 62.3 percent of the outstanding portfolio of Indonesian Islamic rural banks.

innovative design of a range of Sharia-compliant products and services would provide greater financial access to a broader segment of Islamic microfinance customers.

Leveraging Zakat and Islamic Funds

Throughout the Muslim world, microfinance (Islamic or otherwise) is still seen as a philanthropic activity rather than a business enterprise. Consequently, in the context of Islamic microfinance, there is a growing tendency to view zakat (funds donated pursuant to the Muslim obligation to pay alms) as a source of funding. Indeed, given the underlying principle of Islamic finance to promote the welfare of the community, zakat funds appear ideally suited to support Islamic microfinance. However, a heavy reliance on charity is not necessarily the best model for the development of a large and sustainable sector, and more reliable, commercially motivated streams of funding should be explored.

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